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UNCLAS SECTION 01 OF 02 MADRID 000206

C O R R E C T E D C O P Y (ADDED SBU MARKINGS, PARAS 1, 4)

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SUBJECT: ECONOMY CONTINUES DECLINE, RECOVERY REMAINS DISTANT

REF: A. 08 MADRID 707

[B](#). 08 MADRID 1257

[C](#). 08 MADRID 01080

[D](#). 09 MADRID 109

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[1](#)1. (SBU) Summary: Spain's unemployment rate of 14.4 percent is the highest in the European Union (EU), and its economy is officially in a recession. The government is responding to the crisis with a series of stimulus and support measures, relying heavily on deficit spending. With over 3 million jobless workers, unemployment has become the GOS's number one concern, but President Zapatero remains firm in his refusal to consider increasing flexibility of hiring and firing. GOS officials acknowledge that 2009 will be a difficult year, and very recently have begun to follow the lead of others in expressing concern about economic prospects for 2010. Spain's Achilles heal continues to be its slumping residential construction sector, which once fueled about 10 percent of GDP. End summary.

OVERVIEW OF SPAIN'S ECONOMIC SLUMP

[1](#)2. (U) Spain's difficulties began with the downturn in the residential construction sector, which, as recently as 2006, fueled approximately 10 percent of GDP. Home prices rose and construction boomed for several years, until interest rates began to rise sharply. These high rates caused buyers to defer purchasing homes, which led to a collapse in demand in mid-2007 that bankrupted many prominent real estate developers. The amount of unsold units on the market continued to grow for the next year as housing under construction was completed, and prices have declined significantly. Construction companies and workers have been equally affected, as housing starts have almost entirely ceased and hundreds of thousands of workers have lost their jobs. The international credit crisis aggravated these problems, and the global economic downturn has had a negative impact on other important sectors in Spain such as tourism and the auto industry.

[1](#)3. (U) Over the past several months, consumption has stagnated and the Spanish economy has spiraled downwards. The National Statistics Institute (INE) confirmed February 12 that the Spanish economy had contracted by 1 percent in the fourth quarter of 2008, marking the second consecutive quarter of negative growth, and officially placing Spain in a recession for the first time since 1993. Unemployment spiked to 14.4 percent in December according to the EC's statistics agency Eurostat, making Spain the country with the highest level of unemployment in the EU. The silver lining in the

midst of Spain's economic problems has been the strength of its private banks, which are in better shape than their counterparts in other countries, and continue to post profits (ref A and D).

GOS RESPONSE

14. (SBU) Over the past year, President Zapatero has taken a series of actions in an unsuccessful attempt to slow the economy's decline and rally confidence. However, his emphasis over the past year on the importance of maintaining public confidence was criticized as an unwillingness to acknowledge the depth of the difficulties. The GOS implemented a series of stimulus measures, including a 10-18 billion euro tax rebate and relief package in April, and an 11 billion euro infrastructure investment package in October (Refs A and B). In response to the freezing of international credit markets, the GOS has begun to purchase mortgage-backed assets from banks and to guarantee up to 100 billion euros in new bank debt (ref C). It also took steps to give the government the authority to inject capital into banks, though both the GOS and the banks insist this will not be necessary.

15. (U) The GOS's measures, coupled with a slowdown in tax receipts and an increase in unemployment compensation, brought a dramatic end to four years of budget surpluses. The deficit was over 3 percent of GDP in 2008 and will potentially reach 6 percent in 2009. Spain's weakening fiscal position, along with other factors, prompted S&P to downgrade its sovereign debt credit rating from AAA to AA and Moody's to label its rating as "vulnerable."

WHAT THE FUTURE HOLDS

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16. (U) The GOS acknowledges that 2009 will be a difficult year, during which unemployment will continue rise, and the recession will continue. Until recently, GOS officials have asserted that the economy will begin to turn around in the second half of 2009. On February 17, however, Second Vice President and Minister of Economy acknowledged in a congressional hearing that 2010 may also be a tough year for Spain, a prediction that is more in line with general opinion. EU estimates predict a recession and higher unemployment for Spain well into 2010.

17. (U) Spain's Achilles heel, its residential construction sector, continues its downward adjustment. With an estimated one million newly constructed properties left unsold, and prices continuing to decline, many experts say that the housing downturn will continue to have a major impact on Spain's economy. New residential construction has stagnated and property prices have declined. Property estimator TINSA estimates that property prices could fall an additional 20 percent this year, after a 2008 decline of 10-20 percent. For the most part, homeowners are managing to pay their mortgages, with Spanish default levels significantly below U.S. levels. This is in part because of higher downpayment requirements, strict repayment requirements, and a cultural prohibition against being in default on home mortgages. However, defaults rates are beginning to increase, and will continue to do so as unemployment rises and unemployment benefits run out. If defaults increase too much, Spanish banks, particularly its savings banks/cajas, and the financial system could suffer as well.

18. (U) With over 3 million jobless workers, unemployment has become the GOS's number one concern, but President Zapatero remains firm in his refusal to consider increasing flexibility of hiring and firing as called for by business groups, the governor of the Bank of Spain, and the IMF. Many

analysts say that the GOS forecast that unemployment will reach 15.9 percent by year end is unrealistically low. Continued increases in unemployment and contractions in economic activity could lead to even tougher budget decisions for the government. Two of the few factors in favor of the President Zapatero and the ruling Socialists are that: 1) national elections are more than three years away; and 2) popularity ratings for Zapatero and the Socialists, albeit low, are still somewhat higher than those for the scandal-mired opposition Partido Popular.

CHACON